

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

NOTICE OF SOUTH CENTRAL BELL)	
TELEPHONE COMPANY OF AN)	
ADJUSTMENT IN ITS INTRASTATE)	CASE NO. 9056
RATES AND CHARGES TO RECOVER)	
ADDITIONAL DEPRECIATION EXPENSE)	

O R D E R

On June 1, 1984, South Central Bell Telephone Company ("SCB") filed a notice with the Commission proposing to increase its intrastate rates and charges to produce an increase in revenues of \$7.147 million annually to be effective on and after June 21, 1984. SCB requested rates solely to recover additional depreciation expense resulting from the 1984 agreement among SCB, this Commission and the Federal Communications Commission ("FCC") staff setting up represcription of the life and salvage factors used to determine the depreciation rates for SCB's plant located in Kentucky. As a result of this represcription, SCB stated that its annual depreciation expense for property located in Kentucky would increase by \$10.882 million which SCB stated would result in an increased revenue requirement for Kentucky intrastate operations of \$7.147 million.

In order to determine the reasonableness of the request, the Commission suspended the proposed rates and charges for 5 months after the effective date and scheduled a public hearing.

The Attorney General's Consumer Protection Division ("AG") filed a motion to intervene in this matter. This motion was granted and no other parties intervened. On October 23, 1984, the Commission held a public hearing for the purposes of cross-examination of the witnesses of SCB. Briefs were filed with the Commission by November 7, 1984, and all information requested during the hearing has been filed.

DISCUSSION

Prior to approving increased rates resulting from represetation of the life and salvage factors used to determine depreciation rates in a streamlined fashion, the Commission must examine an applicant's financial condition to determine whether it can absorb any of the increased cost. If there is potential for absorption, the Commission will only adjust rates to offset that portion of the increased depreciation expense which cannot be absorbed.

The Commission previously outlined its absorption test guidelines in Orders dated August 11, 1981, and May 5, 1982, in Case No. 8150, Notice of South Central Bell Telephone Company of an Adjustment in its Intrastate Rate and Charges. The August 11, 1981, Order stated the following with regards to the expensing of station connections:

Anticipating that the Commission would adopt the phase-in approach of expensing station connections, Bell requested that a provision be made for it to file tariffs to cover the additional expense in December 1981, 1982, and 1983. The Commission accepts Bell's proposal as it is less costly to the ratepayer and will provide timely rate relief to the company. The limited filing should however be specific to the station connection expense increase

only, and Bell should fully demonstrate validity of this expense in its application. Bell must, moreover, demonstrate, based on actual results, adjusted solely for the effect of rate increases, that absorption of these increased costs would result in Bell not achieving the return on equity allowed in this Order.¹

The criteria laid down in the August 11, 1981, Order were further clarified in the May 5, 1982, Order in this same case:

Interpreting this statement ("Bell must, moreover demonstrate . . . allowed in this Order") to mean that Bell could not adjust its expenses in any manner, the AG demonstrated Bell's ability to absorb a portion of the increase in expenses when leaving expenses at the actual 1981 level. Bell objected to this interpretation of the Commission's statement since it had made adjustments to expenses for known changes approved in the August Order in its general rate case. Moreover, Bell contended that it is inconsistent to require an adjustment to reflect the increase in revenues resulting from a rate case, while not permitting adjustments to expenses on which the Commission had based its decision regarding the amount of increase.

The Commission agrees with Bell in this interpretation. However in future annual periods not affected by a general rate case no adjustments to expenses shall be allowed, but revenues must be adjusted to reflect changes such as increases from regroupings and the annualized effect of new service offerings.²

In this present instance, Case No. 9056, the issue of the Commission's intent in its previous Orders in Case No. 8150 has again been raised due to SCB's proposal to depart from the Commission's long-standing policy of determining rates based on a 12-month historical test period.

¹ Order dated August 11, 1981, Case No. 8150, page 20.

² Order dated May 5, 1982, Case No. 8150, pages 2 and 3.

SCB's application included Exhibit 2 of SCB's Revenue Requirements witness, Mr. C. J. Lathram, which reflected the revenue requirement for represcription in the amount of \$7,147,000 based on intrastate ratios for the 3-month period, January 1 - March 31, 1984.³ The Commission, in its Order of June 21, 1984, expressed its reservations with this proposed departure from its 12-month test period, stating:

Moreover, in addition to the AG's concerns, the Commission is also concerned with SCB's annualizing 3 months of intrastate separations factors to determine its intrastate revenue requirement.⁴

The June 21 Order also stated the following:

The Commission utilizes a historical test period with known and measurable adjustments in determining fair, just and reasonable rates. SCB's proposal to use the first 3 months of 1984, to determine its intrastate separations factors as a substitute for 12-month historical results which was used in the most recent case is SCB's burden to provide as reasonable and may result in less expeditious consideration.⁵

Therein, although confined to the argument of separations factors, the Commission indicated its desire to consider the merits of this case based on the traditional 12-month test period concept.

In response to the June 21 Order, SCB on July 10, 1984, filed additional affidavits and exhibits indicating that it was

³ Application filed June 1, 1984, Notice Exhibit 6, Exhibit 2 of Lathram Affidavit.

⁴ Order dated June 1, 1984, Case No. 9056, page 4.

⁵ Ibid., page 5.

unable to absorb any of the increase in depreciation expense. The exhibits filed were based on the annualization of data for the 5-month period ended May 31, 1984. In support of this 5-month test period, Mr. Lathram stated in his affidavit that, due to the divestiture of the Bell System on January 1, 1984, "operating results subsequent to December 31, 1983, are based on substantially different operations, [therefore] any combination of pre-divestiture and post-divestiture financial results would not be indicative of South Central Bell's performance and financial condition in the post-divestiture environment."⁶ The only additional evidence provided by SCB to meet its burden of proof in supporting the use of the abbreviated 5-month test period was the following narrative by Mr. Lathram:

Kentucky operations were impacted by divestiture in the same manner as the Company's overall operations. In addition, while provisions of the NARUC-FCC separations process did not change at divestiture, application of the separations procedures to Kentucky's post-divestiture operations reflects a greater percentage assignment to the intrastate jurisdiction of investment and costs retained by South Central Bell because the jurisdictional composition of the business functions remaining changed significantly. Therefore, any attempt to present a 12-month historical period which would include both pre- and post-divestiture results would not be indicative of South Central Bell's post-divestiture intrastate financial condition and would be inappropriate for purposes of determining South Central Bell's ability to absorb any or all of the increase in depreciation expense. Exhibits 3 through 7, therefore, reflect actual results of operations based upon the period of January 1, 1984 through May 31, 1984, during which

⁶ Response to June 21, 1984, Order filed July 10, 1984; Lathram testimony, page 2.

South Central Bell in Kentucky operated totally in the post-divestiture environment.

The Commission notes that SCB provided no studies or analyses in support of Mr. Lathram's stated position regarding the inappropriateness of combining pre-divestiture and post-divestiture operations nor did SCB provide any analysis to indicate that 3 or 5 months of results were representative of a typical annual period.

In order to further investigate the merits of SCB's position, the Commission in its October 5, 1984, Order requested that the Lathram exhibits filed in response to the Order of June 21, 1984, be provided based on the 12 months ended May 31, 1984. SCB responded to this request on October 12, 1984, by providing data for the period requested, but with several departures from actual 12 months data. The most profound of these departures was an adjustment to reduce income for the 12-month period by \$12,154,000,⁸ purportedly to reflect the effects of divestiture upon SCB's earnings. At the October 23, 1984, hearing Mr. Lathram was questioned in detail and admitted that this adjustment assumed that the rate of return earned by SCB for the 5 months ended May 31, 1984, was reflective of a "representative" or normal rate of return after divestiture. Therefore, although the

⁷ Ibid.

⁸ Response to October 5, 1984, Order filed October 12, 1984, Exhibit 4, Sheet 1.

Commission requested 12 months of data, the effect of the \$12,154,000 adjustment was to return to a 5-month test period. Mr. Lathram stated SCB's position that such an adjustment was proper because "we must look at what the company's going level of operations are,"⁹ but conceded that this adjustment was novel in the sense that "We did realize . . . we were dealing with five months, rather than 12-months, as required by the Commission rules."¹⁰ Mr. Lathram also stated that he knew of no previous instance in which the Commission has rendered a decision based on 5 months of data as a test period.¹¹

SCB's response filed November 2, 1984, to the Commission's post-hearing request indicated the ability to absorb most of the increased depreciation expense based on a 12-month test period and excluding the "divestiture" adjustment which reduced income by \$12,154,000.¹² Because of the importance of the adjustment and the proposal to in effect allow a 5-month test period, the AG and SCB were asked to brief the critical issues of the case, particularly the interpretation of the absorption test as set forth in previous Orders. Subsequently, briefs were filed by both parties on November 7, 1984. SCB in its brief stated the following with regards to the test period and absorption issues:

⁹ Transcript of Evidence ("T.E."), October 23, 1984, page 37.

¹⁰ T.E., page 38.

¹¹ T.E., page 82

¹² Response to Post-Hearing Request filed November 2, 1984, Item 4.

First, it is apparent that the test, as quoted on page 2 of the memorandum, does not require a twelve month test period or any test period at all. The Commission can use any means to assure itself that the additional revenues and expense will not push the rate of return beyond the authorized level. Second, whatever the Commission intended in 1981, it could not and did not anticipate divestiture and the radical restructuring of the Company's revenues, expenses and investment. Divestiture makes the level of 1983 earnings irrelevant to the Company's ability to absorb additional expense in 1984.¹³

SCB also argued that actual results for the 12-month period ended May 31, 1984, "without proforming" showed that SCB was not earning the rate of return authorized in the previous Order in Case No. 8847, Notice of South Central Bell Telephone Company of an Adjustment in its Intrastate Rates and Charges.

The AG stated that SCB's filing was contrary to previous Commission decisions because "it is neither based on actual results, nor adjusted in a manner identical to that in the Commission's last rate Order."¹⁴ The AG also stated the following with regards to the absorption guidelines:

In Case No. 8150 the Commission created a streamlined procedure designed to permit the utility rate recovery associated with accelerated capital recovery and accounting changes. However, expeditious treatment of these filings was based upon compliance with the Commission's guidelines. These guidelines were designed to reserve litigation of controverted issues for general rate cases. Bell has clearly violated the scope of this proceeding by raising matters, such as post-divestiture separations factors, which were litigated in either the past

¹³ SCB Brief, pages 5 and 6.

¹⁴ AG Brief, page 4.

case ^{or} are currently being debated in the present case.¹⁵

The AG requested that "the Commission apply the absorption test to actual SCB operating results as adjusted for in its Order in Case No. 8847."¹⁶

The Commission, in the evidence of record in this case, has noted its concerns with the abbreviated test-period approach advocated by SCB. The Commission cannot dispute SCB's contention that divestiture has had a profound impact upon the composition of SCB's revenues, expenses, and investment. However, SCB by its position in this case is requesting that the Commission depart from its long-standing policy regarding the use of a 12-month historical test period adjusted solely for known and measurable changes. In order to attempt to meet its burden of proof to persuade the Commission to deviate from this policy, SCB would have to submit detailed and substantial evidence to prove that the alternative test period proposed is "representative" of normal post-divestiture conditions. Such a case would be difficult to establish in any instance because of the random and seasonal variations which occur in a short period of time, and is particularly troublesome in this instance because of the absorption guidelines set forth in previous Commission decisions which further narrow the scope of allowable adjustments. The Commission concurs with the AG's position that the streamlined

15 Ibid.

16 Ibid.

procedure set up in Case No. 8150 was designed to expeditiously allow a utility rate recovery in single-issue cases, and is therefore of benefit to the utility. The Commission also concurs with the AG's assessment that controversial and complicated issues such as the effects of divestiture upon SCB's earnings are more properly examined in the context of a full-scale rate case where all parties and positions are adequately represented, as the Commission is aware that its actions in this instance could be viewed as precedent-setting in other matters involving SCB (and other utilities). The Commission reminds SCB of its June 21, 1984, Order which stated that the use of an abbreviated test period was "SCB's burden to prove as reasonable." Based on the evidence of record and in consideration of the future implications of this case, the Commission is of the opinion that Bell has failed to provide substantive evidence to persuade the Commission to depart from the 12-month test period.

An example of this lack of evidence is SCB's use of its \$12,154,000 adjustment for the effects of divestiture to support its position. This adjustment is nothing more than a mathematical computation which converts 12 months of actual operations to 5 months of divested operations, annualized. Such an adjustment has no validity in attempting to reflect a test period representative of normal post-divestiture operations and is unsupported by any credible or detailed analysis of post-divestiture conditions. SCB also proposed no adjustments to eliminate seasonal or random variations on the 5 months of data, but merely assumed that the 5

months of post-divestiture operations were representative. The Commission notes that SCB's rate of return has continued to increase in the post-divestiture months subsequent to its proposed test period in this case.¹⁷ SCB noted in its post-hearing response that these increasing rates of return reflected "considerable fluctuation on a month-to-month basis."¹⁸ These month-to-month fluctuations are precisely the reason why the Commission has reservations regarding SCB's original proposal to annualize 3 months of operating results and its subsequent proposal to annualize 5 months of operating results. When actual results for a full year--post-divestiture--are available, the Commission can have increased confidence in a stated additional annual revenue need. Those results will reflect the two "true-ups" for which AT&T's Plan of Reorganization provided, one at the end of March, 1984, and the other at the end of December, 1984.¹⁹ The plan of reorganization explicitly recognizes that mistaken assignments and imbalances will occur following a divestiture of this magnitude.²⁰ This is all the more reason why the Commission cannot accept 3 or 5 months of post-divestiture results as representative.

¹⁷ Response to Post-Hearing Request, Item 2.

¹⁸ Ibid.

¹⁹ T.E., page 46.

²⁰ Plan of Reorganization dated December 16, 1982, pages 233-234 and 277-278.

Based on the concerns expressed herein, the Commission has determined that the 12 months ended May 31, 1984, should be the test period in this instance. The Commission also is of the opinion that proposed adjustments of \$12,154,000 for the effects of industry restructure and of \$343,000 and \$420,000 for management salary plan changes effective in October, 1983, and April, 1984, are inappropriate and should be rejected. Regarding the management salary adjustments SCB in its brief stated that Mr. Lathram adjusted expenses in this case in the same manner as was done in Case No. 8150.²¹ However, the Commission expressly stated in Case No. 8150 that it approved Bell's method of "adjustments to expenses for known changes approved in the August Order in its general rate case."²² The October, 1983, and April, 1984, salary changes were not approved in SCB's previous rate case Order in Case No. 8847 and should not be examined in subsequent single-issue cases such as this proceeding. Therefore, SCB's adjusted operations are stated as follows:

²¹ SCB Brief, page 4.

²² Order dated May 5, 1982, Case No. 8150, page 2.

	<u>SCB Proposed*</u>	<u>Commission Adjustments</u>	<u>Adjusted*</u>
Income Available for Capital	\$81,792,000	\$ -0-	\$81,792,000
Effect of Known Changes	7,466,000	763,000	8,229,000
Adjusted Income Available	\$89,258,000	\$ 763,000	\$90,021,000
Divestiture Adjustment	12,154,000	<12,154,000>	-0-
Adjusted Income Available	\$77,104,000	\$12,917,000	\$90,021,000
Regulatory Adjustments	6,407,000	-0-	6,407,000
KPSC Income Available	<u>\$83,511,000</u>	<u>\$12,917,000</u>	<u>\$96,428,000</u>

***Average Basis**

Based on this level of adjusted income, SCB has the potential to fully absorb the increased depreciation expense resulting from the represcription.²³ The Commission wishes to advise all parties that it has not made all adjustments to decrease expenses. One major adjustment is the license contract expense adjustment made in Case No. 8847, but not made in this case. Had these adjustments been made, SCB's ability to absorb would have been even greater. The Commission wishes to note that the increase in depreciation expense may not affect SCB's earnings immediately as SCB indicated that it would not begin booking the additional expense until final approval by the FCC in January, 1985.²⁴ The

23	KPSC Income Available	\$96,428,000
	- Income Effect of Depreciation Changes	3,458,000**
	Adjusted Income	\$92,970,000
	Income Required to Earn KPSC Authorized Rate of Return (Based on Average Capital at 11.475% Rate of Return)	\$92,138,000
	Excess	\$ 832,000

** Based on intrastate ratios for 12 months ended May 31, 1984.

24 T.E., page 85.

Commission further notes that SCB will again have the opportunity to recover the additional depreciation expense resulting from the represcription in SCB's rate case currently pending before the Commission if its earnings are shown to be inadequate in that proceeding.

FINDINGS AND ORDERS

The Commission, after consideration of the evidence of record and being advised, finds that:

1. SCB should be allowed to book the increased depreciation rates agreed to among SCB, this Commission, and the FCC at such time as final approval of those rates is granted by the FCC.

2. SCB should notify the Commission should those rates agreed upon among SCB, this Commission and the FCC be modified in any respect by the FCC.

3. The rates and charges proposed by SCB should be denied as SCB has the potential to fully absorb the increase in depreciation expense.

4. Although rate design was an issue in this case no additional revenues have been granted herein and no decisions on rate design are warranted.

5. The rates and charges of SCB in effect under authority of the Commission prior to this date should continue in effect.

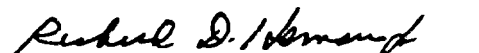
IT IS THEREFORE ORDERED that the depreciation rates agreed upon in the 1984 agreement among SCB, this Commission, and the FCC be and they hereby are approved and may be booked by SCB at such time as final approval of those rates is granted by the FCC.

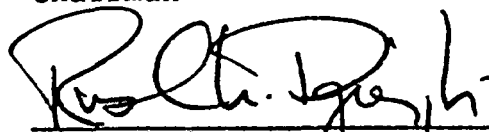
IT IS FURTHER ORDERED that the rates and charges requested by SCB be and they hereby are denied.

IT IS FURTHER ORDERED that the rates and charges of SCB in effect under authority of the Commission prior to this date should continue in effect.

Done at Frankfort, Kentucky, this 21st day of November, 1984.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Secretary